



EXPOSURE DRAFT

Proposed Revisions to the AICPA Code of Professional Conduct

Leases Interpretation (ET sec. 1.260.040)

AICPA Professional Ethics Division
October 20, 2017

Comments are requested by January 15, 2018

Prepared by the AICPA Professional Ethics Executive Committee for comments from those interested in independence, behavioral, and technical standards matters. Comments should be addressed to the Professional Ethics Division, Ethics-ExposureDraft@aicpa-cima.com

*Copyright © 2017 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775*

Permission is granted to make copies of this work provided that such copies are for personal, intra-organizational, or educational use only and are not sold or disseminated and provided further that each copy bears the following credit line: "Copyright © 2017 by the American Institute of Certified Public Accountants, Inc. Used with permission."

October 20, 2017

This exposure draft contains an important proposal for review and comment by the AICPA's membership and other interested parties regarding revisions for possible adoption by the Professional Ethics Executive Committee (PEEC). The text and an explanation of the proposed revisions are included in this exposure draft.

After the exposure period has concluded and PEEC has evaluated the comments, PEEC may decide to publish the proposed revisions in a final release. Once published, the revisions will become effective on the last day of the month in which the release is published in the *Journal of Accountancy*, unless otherwise stated in the release.

Your comments are an important part of the standard-setting process; please take this opportunity to comment. Responses must be received at the AICPA by January 15, 2018. All written replies to this exposure draft will become part of the public record of the AICPA and will be available at the following link: www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx. PEEC will consider comments at its subsequent meetings.

Please email comments to the Professional Ethics Division (Ethics-ExposureDraft@aicpa-cima.com).

Sincerely,

Samuel L. Burke, Chair
AICPA Professional Ethics Executive Committee

Jim Brackens, Vice President
Ethics and Practice Quality

Professional Ethics Executive Committee (2016–2017)

Samuel L. Burke, <i>Chair</i>	Gregory Guin
Coalter Baker	Brian S. Lynch
Carlos Barrera	Bill Mann
Stanley Berman	William McKeown
Michael Brand	Andrew Mintzer
Chris Cahill	Steven Reed
Tom Campbell	James Smolinski
Robert E. Denham	Lisa Snyder
Anna Dourkourekas	Laurie Tish
Janice Gray	Shelly VanDyne

Leases Task Force

Blake Wilson, *Chair*

Bill Mann

Alan Gittelson

David East

Chris Cahill

Nancy Miller

Ethics Division Task Force Staff

Brandon Mercer, CPA, CGMA

Senior Manager, AICPA Professional Ethics Division

Contents

	Page
Explanation of the Proposed Revision.....	6
Text of Proposed Revision to “Leases” Interpretation.....	11
Final Text of Proposed Revision to “Leases” Interpretation.....	13

Explanation of the Proposed Revision

The Professional Ethics Executive Committee (PEEC) is exposing for comment a revision to the “[Leases](#)” interpretation (ET sec. 1.260.040)¹.

I. Background

In December 2014, PEEC revised the “[Loans and Leases with Lending Institutions](#)” interpretation (ET sec. 1.260.020). PEEC did not make any revisions regarding leases at that time due to the pending status of the FASB project to revise the accounting model for leases under generally accepted accounting principles (GAAP). FASB issued its updated standard for leases (the update) in February 2016, at which time PEEC established the Leases Task Force to review the extant “Leases” interpretation and determine whether revisions or updates were necessary.

Consistency With Regulators and Other Standard Setters

PEEC reviewed the FASB updated standard and the related independence requirements of other standard setters and regulators, including the Securities Exchange Commission (SEC), Governmental Accounting Office (GAO), Department of Labor (DOL), and the International Ethics Standards Board for Accountants (IESBA). In its review, PEEC noted that the standards it reviewed either did not explicitly address leases, or if they addressed leases, did not reference the applicable lease accounting model. Where leases were specifically addressed, a significant factor in the evaluation of independence was the materiality of the lease, using both quantitative and qualitative considerations. Where leases were not specifically addressed, a conceptual framework approach was typically required to conclude whether threats were at an acceptable level or whether safeguards were available to reduce the threats to an acceptable level. As AICPA is the only standard-setting body that references GAAP categorization as a bright-line test for independence, PEEC believed that the extant interpretation should be revised to provide consistency and to properly address the significant factors that affect threats to independence.

Threats and Safeguards Approach Replaces GAAP Categorization Approach

The proposal replaces the extant GAAP categorization approach with a conceptual framework approach, allowing for the consideration of factors that truly affect the covered member’s objectivity and professional skepticism. PEEC does not believe that objectivity and professional skepticism are affected by whether a lease is an operating lease or a capital lease, but believes that other factors related to the lease and the relationship should be considered in arriving at a conclusion on independence. In its analysis, PEEC considered various factors present when a member has a lease with an attest client and the significance of the factors to the level of threats to independence, including but not limited to: materiality of the lease to the covered member and to the attest client, whether there are multiple leases between the parties, and the role of the covered member at the firm and on the attest engagement. PEEC has incorporated these factors into the proposal, either as minimum safeguards (paragraph .02) or as factors to consider in evaluating the threats to independence (paragraph .03).

Applicability

The proposed revision addresses all leases between covered members and attest clients except automobile leases with lending institution attest clients, which are addressed in the “Loans and Leases with Lending Institutions” interpretation (ET sec. 1.260.020). In addition, the requirements of the proposed revision extend to

¹ All ET sections can be found in AICPA *Professional Standards*.

the [immediate family](#) of the covered member and to [affiliates](#) of a [financial statement attest client](#). However, since the definition of an affiliate does not include an individual who has significant influence or control over the attest client, the extant and proposed revision does not extend to leases between a covered member and these individuals. Accordingly, such leases would be evaluated utilizing the “[Conceptual Framework for Independence](#)” (ET sec. 1.210.010) if the covered member determined threats were not at an acceptable level.

II. Leases Interpretation

General Approach

The extant “Leases” interpretation provides that a lease between the covered member and attest client does not impair independence if the lease is an operating lease, the lease terms are comparable with leases of a similar nature, and all amounts are paid in accordance with the lease terms and provisions. The extant interpretation also provides that a capital lease impairs independence because it is considered be a prohibited loan with the attest client. While the GAAP lease categorization requirements have been eliminated from the proposed revised interpretation, the other requirements remain in the proposed revised interpretation as minimum safeguards. Once these minimum safeguards are met (where applicable), the member is required to use a threats and safeguards approach, evaluating any other threats identified and applying safeguards when necessary. The proposal also contains provisions addressing leases entered into by the covered member or attest client prior to the lease relationship being subject to the “Independence Rule,” (ET sec. 1.200.001) as well as leases of a covered member’s primary residence.

Minimum Safeguards for Leases

Market Terms Established at Arm’s Length and Compliance With Payment Terms

The PEEC believes that the familiarity or self-interest threat to independence could exist if a covered member and attest client enter into a lease that is less than arm’s length, at a bargain rate in regard to payments, or contains terms that are not consistent with the market due to the attest relationship. The extant standard contains a requirement that the lease be entered under the lessor’s normal procedures and that the lease is comparable to similar leases. PEEC considered these requirements as well as the fact that in some markets, there may be a scarcity of access to other leases for comparison, and therefore the nature of the subject property may not lend itself to easy comparison. In addition, if the lease is entered into at less than arm’s length under terms that are well below or above market terms, the threat to independence has already been created, and a comparison to other leases would have no impact. Accordingly, PEEC determined that the requirement that a lease be on market terms that are established at arm’s length more effectively addresses the self-interest and familiarity threats created when lease terms are influenced by the attest relationship.

The requirement that all payments be made in accordance with the lease terms is to safeguard against any unpaid amounts becoming a prohibited loan between the covered member and the attest client. This requirement is consistent with the requirements of the extant standard, and was not removed by PEEC.

Leases Material to the Attest Client or Certain Covered Members

PEEC spent a significant amount of time considering the impact of materiality on the significance of threats to independence, and considered whether the impact varies based upon the type of covered member that is a party to the lease in question. For example, an immaterial lease to a junior-level staff member on the attest engagement team is likely to have less impact on objectivity and have more safeguards available than a material lease to the engagement partner or other individual with a significant role on the engagement team. In addition, if the lease is material to the attest client, the member may be performing attest procedures on the lease and may be in a position of evaluating the member’s own solvency as it relates to the collectibility of the lease. In some situations, such as when a lease is material to the attest client, the appearance of independence may be affected to the point that safeguards are not available. PEEC determined that with respect to materiality, the following situations create threats to independence so significant that no safeguards can reduce the threat to an acceptable level:

- a. The lease is material to a member of the attest engagement team or an individual in a position to influence the attest engagement who is also a party to the lease.
- b. The lease is material to the firm and the firm is a party to the lease.
- c. The lease is material to the attest client and the lease is with a covered member.

These situations are reflected in paragraph .02 of the proposed standard as minimum safeguards that should be met in order to maintain independence. If the lease meets the requirements of paragraph .02, any other threats should be evaluated using the conceptual framework approach noted in paragraph .03.

Required Evaluation of Other Threats

The proposed standard requires in paragraph .03 that if a lease is not already prohibited under paragraph .02, the covered member should evaluate the lease and determine whether there are any other threats to independence not addressed by paragraph .02. The paragraph provides the following examples of factors that should be considered when identifying and evaluating threats to independence under paragraph .03:

- a. The role of the covered member on the attest engagement and with the firm
- b. Materiality of the lease to the covered member (other than those addressed in paragraph .02)
- c. Whether there are multiple leases with the attest client, and the aggregate materiality of those leases to the covered member and the attest client
- d. The extent to which the lease will be subject to attest procedures or financial statement disclosures

If the covered member considers these factors and determines that threats are at an acceptable level, independence would not be impaired.

Grandfathered Leases

PEEC determined that in some situations, such as when a lease is in existence prior to independence being required, consistency with the treatment in the “Loans and Leases With Lending Institutions” interpretation of home mortgages, secured loans, and immaterial unsecured loans should be maintained as it relates to similarly timed leases. PEEC determined that the same requirements regarding market terms and payment compliance should apply to these leases, as similar requirements would apply to a loan. However, PEEC determined that a materiality requirement should not apply to these leases as a bright-line test, as there would be no relief for leases entered into prior to independence being required because the requirements would be the same as all other leases.

Leases Entered Into Prior to Independence Being Required

PEEC considered that leases may not have been subject to the independence requirements at the time the lease was entered into, and determined that the proposal should provide some relief for certain leases that were entered into prior to independence being required, regardless of materiality. PEEC noted that similar situations related to loans are addressed in the “Loans and Leases with Lending Institutions” interpretation. Under that interpretation, a loan entered into prior to independence being required is permitted in certain situations, without regard to materiality of the loan payments. PEEC determined that a similar approach to leases is appropriate. This approach is reflected in paragraph .04 of the proposed standard and addresses situations in which, for example, a member enters into the lease prior to becoming a covered member or the client becoming an attest client. PEEC believed it was also appropriate to specifically address situations in which an acquisition by or of the client or a covered member renders the lease subject to the “Independence Rule” and provide similar relief.

Leases of the Covered Member’s Primary Residence

Paragraph .05 of the proposal addresses primary residence leases. PEEC members raised concerns that members may be forced to move from their primary residences if, for example, the staff member's landlord becomes an attest client of the firm. In order to avoid any unintended consequences or hardships for clients and members in some primary residence lease situations, and given the likely materiality of a primary residence to the covered member, PEEC determined that it was appropriate to provide relief to some extent to covered members that may live in an apartment or other residence that is owned by an attest client.

PEEC believes that a lease for a primary residence is similar in nature to a home mortgage because of the nature of the subject property, and should carry similar safeguards, with the exception of collateral related requirements. However, PEEC was not in favor of allowing covered members to enter new primary residence leases during the period of professional engagement, unless the lease meets the requirements of paragraphs .01 and .02 of the proposal. Because the resulting guidance for primary residences mirrors that of grandfathered leases in paragraph .04, PEEC has included in paragraph .05 a direct reference to the requirements in paragraph .04 for other permitted leases. PEEC determined that primary residence leases may be prevalent enough that it should be specifically noted in the proposal.

Effective Date

The committee believes that members may need significant time to implement the proposed revisions, consistent with the effective date of the FASB ASU No. 2016-02. As such, PEEC recommends that the interpretation be effective for leases entered into after December 15, 2019, consistent with the FASB ASU effective date for private companies.

Request for Specific Comments

Although PEEC welcomes comments on all aspects of these proposed interpretations, it specifically requests feedback on the following:

1. Are there any exceptions that should be extended to affiliates of financial statement attest clients?
2. Are there are other situations or circumstances that should be grandfathered which are not grandfathered in the proposal?
3. Do you agree with the application of the materiality safeguard in paragraph .02? Specifically, do you agree that there are no safeguards available when a covered member specified in paragraph .02 has a lease with the attest client that is material to that covered member?
4. Do you agree that there are no safeguards that would reduce the threat to an acceptable level when the lease with a covered member is material to the attest client?
5. Do you agree that the requirements of the proposal should extend to immediate family, as proposed?
6. What do you foresee as major obstacles to implementation or hardships? Do you expect significant changes in quality controls, procedures, tools, or technology to monitor leases?
7. Do you agree that it is appropriate to grandfather primary residence leases in a similar manner to home mortgages, as proposed?
8. Are there any other factors affecting the significance of the threats to independence that you believe should be added to paragraph .03? Do you believe any of the factors in paragraph .03 should be removed?
9. Do you agree that an effective date consistent with the FASB Update effective date for private companies is appropriate (December 15, 2019)? If not, what is a more appropriate effective date?

Text of Proposed Revision to “Leases” Interpretation

[Additions appear in boldface italic and deletions are in strikethrough.]

1.260.040 Leases

.01 When ~~If a covered member enters into a lease ing agreement with an attest client during the period of the professional engagement, the self-interest, familiarity, and undue influence threats to the covered member’s compliance with the “Independence Rule” [1.200.001] may exist. would be at an acceptable level and independence would not be impaired if all the following safeguards are met:~~

- ~~a. The lease meets the criteria of an operating lease (as described in GAAP).~~
- ~~b. The terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature.~~
- ~~c. All amounts are paid in accordance with the lease terms or provisions.~~

This paragraph excludes leases addressed by paragraph .04 of the “Loans and Leases With Lending Institutions” interpretation [1.260.020] of the “Independence Rule” [1.200.001].

.02 If a covered member enters into a lease with an attest client during the period of the professional engagement, ~~Threats to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards, and independence would be impaired, if a covered member has a lease that meets the criteria of a capital lease (as described in GAAP). Accordingly, independence would be impaired because the lease would be considered to be a loan with an attest client. unless all of the following safeguards are met during that period:~~

- a. The lease is entered into on market terms and established at arm’s length.***
- b. All amounts are paid in accordance with the lease terms or provisions.***
- c. The lease is not material to any of the following parties to the lease:***
 - i. The firm***
 - ii. An individual participating on the attest engagement team***
 - iii. An individual in a position to influence the attest engagement***
 - iv. The attest client***

.03 If the covered member meets the safeguards in paragraph .02, as applicable, the covered member should evaluate the significance of any other threats to determine whether the threats are at an acceptable level. If the covered member determines that threats are not at an acceptable level, the covered member should apply additional safeguards to eliminate or reduce the threats to an acceptable level. If no safeguards are available to eliminate or reduce threats to an acceptable level, independence would be impaired. The significance of the threats will depend on factors such as the following:

- a. The role of the covered member on the attest engagement or with the firm***
- b. Materiality of the lease to the covered member, other than those covered members identified in paragraph .02***

- c. **Whether multiple leases are entered into with the attest client and, if so, the aggregate materiality of those leases to the covered member or the attest client**
- d. **The extent to which the lease will be subject to attest procedures or financial statement disclosures**

Grandfathered Leases

.04 Irrespective of materiality, threats to compliance with the “Independence Rule” [1.200.001] would be at an acceptable level and independence would not be impaired provided that the lease is entered into on market terms and established at arm’s length, and during the period of professional engagement all amounts are paid in accordance with the lease terms and provisions, the terms do not change in any manner not provided for in the original lease, and any of the following conditions are met:

- a. **The covered member entered into the lease with the attest client prior to becoming a covered member with respect to the attest client.**
- b. **The covered member entered into the lease with a counterparty for which independence was not required, and that counterparty to the lease later becomes, acquires, or is acquired by an attest client.**
- c. **The attest client entered into the lease with a counterparty which was not required to be independent of the attest client, and that counterparty to the lease later acquires or is acquired by the covered member.**
- d. **The lease existed prior to December 15, 2019 and the lease was permitted under the preexisting requirements of the “Independence Rule” [1.200.001] and its interpretations.**

Automatic renewals provided for in the original lease are not considered changes in terms for purposes of this interpretation.

Covered Member Leases Primary Residence from Attest Client

.05 Irrespective of materiality, if a covered member leases his or her primary residence from a lessor attest client, threats to compliance with the “Independence Rule” [1.200.001] would be at an acceptable level and independence would not be impaired, provided the covered member complies with the provisions in paragraph .04.

.06 This paragraph **interpretation** excludes leases addressed by [paragraph .04](#) of the “Loans and Leases with Lending Institutions” interpretation [1.260.020] of the “Independence Rule” [1.200.001].

.07 This interpretation is effective December 15, 2019, with early implementation allowed.

Final Text of Proposed Revision to “Leases” Interpretation

1.260.040 Leases

- .01 When a *covered member* enters into a lease with an *attest client*, self-interest, familiarity, and undue influence *threats* to the *covered member's* compliance with the “Independence Rule” [1.200.001] may exist.

This paragraph excludes leases addressed by paragraph .04 of the “Loans and Leases With Lending Institutions” interpretation [1.260.020] of the “Independence Rule” [1.200.001].

- .02 If a *covered member* enters into a lease with an *attest client* during the *period of the professional engagement*, threats to compliance with the “Independence Rule” [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*, unless all of the following *safeguards* are met during that period:

- a. The lease is entered into on market terms and established at arm’s length.
- b. All amounts are paid in accordance with the lease terms or provisions.
- c. The lease is not material to any of the following parties to the lease:
 - i. The *firm*;
 - ii. An individual participating on the attest engagement team;
 - iii. An *individual in a position to influence the attest engagement*;
 - iv. The *attest client*.

- .03 If the *covered member* meets the *safeguards* in paragraph .02, as applicable, the *covered member* should evaluate the significance of any other *threats* to determine whether the *threats* are at an *acceptable level*. If the *covered member* determines that *threats* are not at an *acceptable level*, the *covered member* should apply additional *safeguards* to eliminate or reduce the *threats* to an *acceptable level*. If no *safeguards* are available to eliminate or reduce *threats* to an *acceptable level*, *independence* would be *impaired*. The significance of the *threats* will depend on factors such as the following:

- a. The role of the *covered member* on the *attest engagement* or with the *firm*
- b. Materiality of the lease to the *covered member* other than those *covered members* identified in paragraph .02
- c. Whether multiple leases are entered into with the *attest client* and, if so, the aggregate materiality of those leases to the *covered member* or the *attest client*
- d. The extent to which the lease will be subject to attest procedures or financial statement disclosures

Grandfathered Leases

- .04 Irrespective of materiality, *threats* to compliance with the “Independence Rule” [1.200.001] would be at an *acceptable level* and *independence* would not be *impaired* provided that the lease is entered into on market terms and established at arm’s length,

and during the *period of professional engagement* all amounts are paid in accordance with the lease terms and provisions, the terms do not change in any manner not provided for in the original lease, and any of the following conditions are met:

- a. The *covered member* entered into the lease with the *attest client* prior to becoming a *covered member* with respect to the *attest client*.
- b. The *covered member* entered into the lease with a counterparty for which *independence* was not required, and that counterparty to the lease later becomes, acquires, or is acquired by an *attest client*.
- c. The *attest client* entered into the lease with a counterparty which was not required to be independent of the *attest client*, and that counterparty to the lease later acquires or is acquired by the *covered member*.
- d. The lease existed prior to December 15, 2019 and the lease was permitted under the preexisting requirements of the “Independence Rule” [1.200.001] and its interpretations.

Automatic renewals provided for in the original lease are not considered changes in terms for purposes of this interpretation.

Covered Member Leases Primary Residence from Attest Client

- .05 Irrespective of materiality, if a *covered member* leases his or her primary residence from a lessor *attest client*, *threats* to compliance with the “Independence Rule” [1.200.001] would be at an *acceptable level* and *independence* would not be *impaired*, provided the *covered member* complies with the provisions in paragraph .04.
- .06 This interpretation excludes leases addressed by [paragraph .04](#) of the “Loans and Leases with Lending Institutions” interpretation [1.260.020] of the “Independence Rule” [1.200.001].
- .07 This interpretation is effective December 15, 2019, with early implementation allowed.